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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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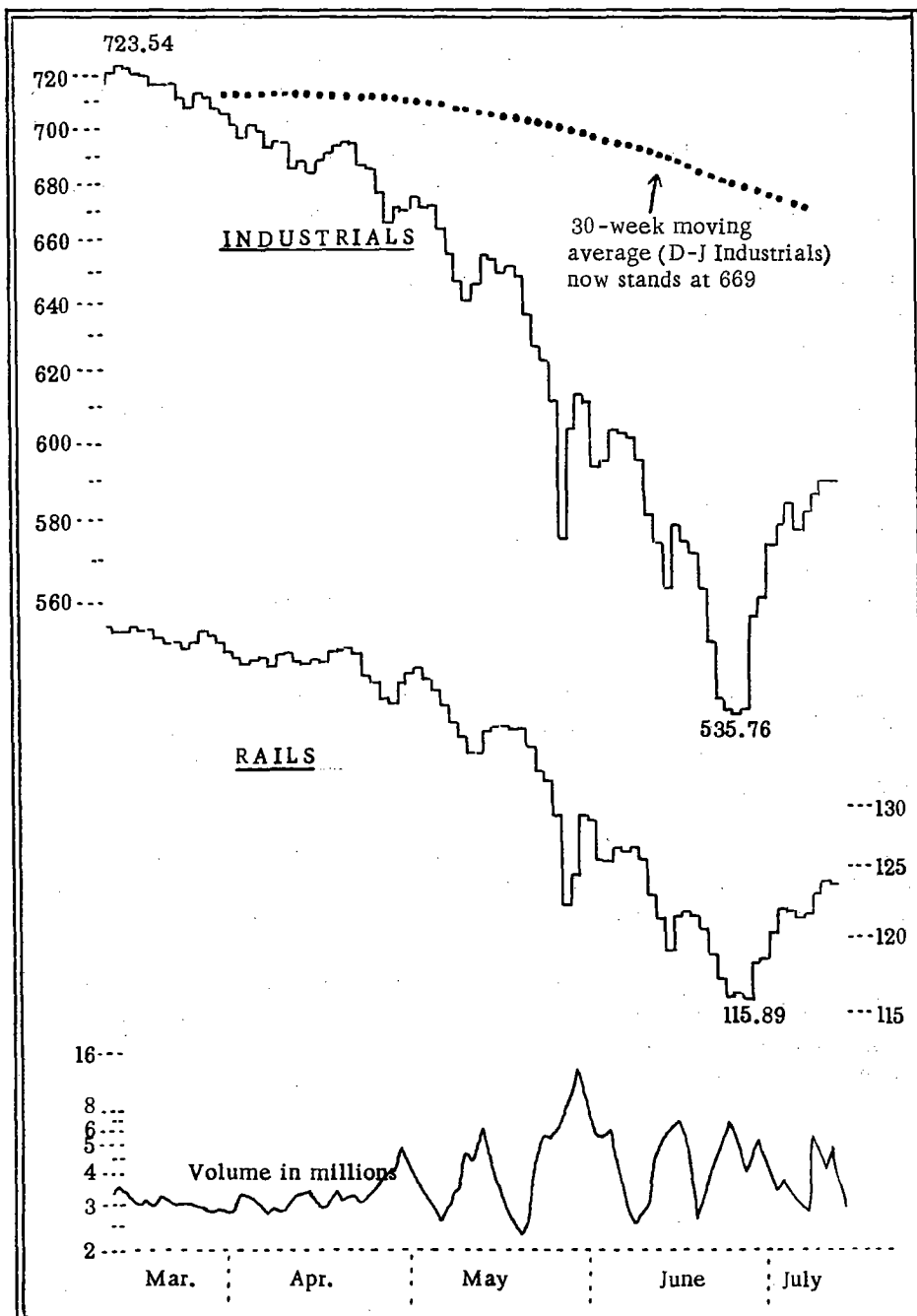
Page 1

THE MARKET For the past two-and-one-half weeks a secondary reaction has been correcting the excesses of the preceding primary downswing. As is always the case, the exact beginning of the upward correction was difficult if not impossible to detect. From the 535.76 low of June 26, Industrials rose on ten out of eleven consecutive trading days. In so doing, the senior Average retraced 28% of the losses sustained on the entire second bear leg (which began in March, 1962). Since bear market reactions tend to be violent and much more rapid than the primary downswings which they correct, the action so far can only be considered par for the course.

The last Letter stated that most important secondaries come in two stages (two main upward thrusts separated by a decline). The action since June 26 must be considered part (or all) of the first upward thrust. The odds now favor a nearby "shakeout" (which could erase perhaps 1/3 to 1/2 of the rise) followed by a second upward move which will probably go to new recovery highs.

Declines such as the one discussed above often terminate on a day of high (even frightening) volume. Following a decline of this type (which could start at any time) I believe trading positions will be in order. It should be remembered that the current secondary has arrived following an historic 200 point "crash" collapse. In view of this and in view of the fact that secondaries normally last three weeks to three months, I continue to believe (as stated in Letter 184) that "the correction will be of the larger and more sustained variety." (I suggest that readers review the 1929-30 action as outlined in the last Letter).

I have been asked at what point I think the current upmove will finally end. Very simply, neither I nor anyone else knows. The halfway level of the Industrial decline comes at 635. This level should offer considerable resistance. Also of interest is the position of the 30-week moving average of the Industrials (see chart



Page 2 on page 1). This line has been dropping at the rate of about five points per week and now stands at 665. By early August the moving average will be at approximately the 650 level, and thus another barrier to upside progress will be within close range of the halfway level (635) of the 1962 decline. I therefore see the 635-650 zone as an impressive area of resistance to any extension of the rise from this area.

SUNDRY THOUGHTS The rally from the June 26 lows has already produced results. A few investment services have proclaimed "a new primary bull market". Others (who have remained bullish throughout the collapse) hasten to announce that the rise "confirms" the fact that it was not really a bear market at all. Friends call to ask me whether a new bull market has started. They seem to think that I have some mysterious method of knowing what will happen a month or six months from now. A subscriber asked me "if I would cut my right arm off if Industrials went to new highs by the end of the year?" I told him I wouldn't bet my arm on whether San Diego received a snowstorm tomorrow. Everyone wants certainty in a business where there is no certainty. We must deal with probabilities in the market -- not certainties. Amateurs who demand "a sure thing" each day should leave the market alone. Nothing is sure. Those who kept their money in savings banks over the last twenty years thought that was a sure thing, but they have seen half of their purchasing power evaporate through two decades of planned and unplanned inflation, political handouts, and flabby thinking.

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Whether through luck or something else, I have been fortunate enough to collect a large number of subscribers and "pen-pals" who are both serious market students and possessors of good sense. Thus, Dr. Sloan Wilson writes me a note regarding the five "New Era" markets in our nation's history: "The first New Era peak occurred in August, 1835, during the Bank Credit Land Boom. The second was in April, 1864, during the Civil War Boom. The third was during the period of the gold resumption prosperity -- July, 1881. The fourth was in September, 1906, the period which has been called one of the great eras of corporate prosperity ('the railroads forever'). The next peak occurred at the end of the New Era prosperity period of the twenties, September, 1929. To this we must, of course, add the sixth in which the peak was reached in December, 1961. The percentage of decline following these first five peaks was 65%, 63%, 47%, 42% and 84%. I have averaged these declines and find this to be 60%.

"All of these facts seem to point out that the ordinary person must learn about New Era bull markets from history -- and I must also hasten to add that he who does not know history will repeat the mistakes therein. Perhaps we should all realize that the knowledge that we have is based almost 100% on history. Each time I make a diagnosis it is based on historical facts."

Will history repeat? Dow thought it would. Much of his writing emphasized the single inevitable factor in the market -- change.

All of which may serve as a general guide for the speculator or trader -- but it cannot be of any use to them during the short swings of a month to a few months duration. Following the initial rise which occurred from the 1929 lows, a decline ensued, but a new advance started shortly. Bears were horrified to witness what seemed like a new bull market the following spring. The smart traders bought in late '29 and sold out when the reaction "blew its top" in March and April of 1930. The hopefuls came in during the spring of 1930 and went broke with the cry of "another New Era" still on their lips.

Will the current secondary upmove develop into a real "blow-off"? Under the guiding hand of a frightened and deficit-happy administration it could happen. The Federal Reserve Board has already made it easier for margin gamblers, and "Big Business" is being wooed with assorted depreciation "come-ons". Major Angus even foresees Bobbie Kennedy giving a party and shoving Mr. Blough and Barry Goldwater into the swimming pool together.

Perhaps the wisest words on the subject were written many years ago by Jesse Livermore. "Speculators in stock markets have lost money but I believe it is a safe statement that the money lost by speculation alone is small compared with the gigantic sums lost by so-called investors who have let their investments ride.

"From my viewpoint, the investors (ed. note -- I believe he means "permanent bulls") are the big gamblers. They make a bet, stay with it, and if it goes wrong, they lose it all. The speculator might buy at the same time, but if he is an intelligent speculator, he will recognize -- if he keeps records -- the danger signal warning him all is not well. He will, by acting promptly, hold his losses to a minimum and await a more favorable opportunity to re-enter the market."

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Meanwhile, along with the stock marketeers and the businessmen, the bondholders are also having their troubles. Those who thought the next market tumble would light the fuse under the bond market again ("rotten business -- lower interest rates -- thus higher bond prices") are already licking their financial wounds.

Some time ago I advanced the contrary opinion that the next bear market would drive this country -- not towards more spending and "pump-priming" -- but towards fiscal conservatism. After all, when a man is broke he discovers that his friends are less interested in his promotion schemes. Thus last week France apologized as she removed 112 million in U.S. gold; Switzerland

took 25 million in gold with no comment. The road to fiscal insolvency is thereby 137 million dollars nearer.

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Along with this line of thinking, I quote from my friend Elliot Janeway's recent Letter (Janeway was one of the very few economists to predict the market and business downturn). "Hand in hand with political doubts and questioning about taxes and the deficit goes the certainty of further economic squeeze. Meanwhile,.... the pressure on the dollar is already forcing a drive towards austerity. There's no longer any uncertainty over the direction in which the authorities are moving to drive short-term money rates. It's up -- the only question about their target is whether they dare try to put the rediscount rate up a full point. This effort to push short-term rates up in spite of a shaky economy represents a departure on the part of the Federal Reserve Board from its familiar policy of following the forces of the market place. If not for the pressure on the dollar, it is clear that the trend of money rates would be down."

BUSINESS These Letters are read by many businessmen as well as by investors and traders. In a surprising number of cases, the businessmen have only a passing interest in stocks from the standpoint of investing. Their real interest in the market lies in its barometric properties, and they follow Dow's Theory much as the physician follows the readings of a patient's thermometer. These businessmen are intelligent enough to realize that the Averages, as interpreted under Dow's Theory, are no infallible guide to corporate riches. But they also are aware that the market has a better record of predicting forthcoming economic contractions and expansions than has any man or group of men.

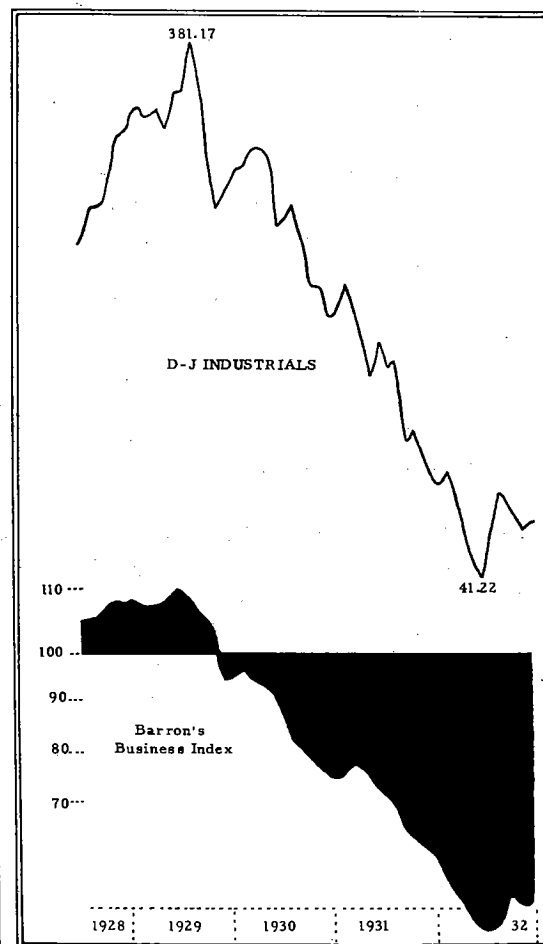
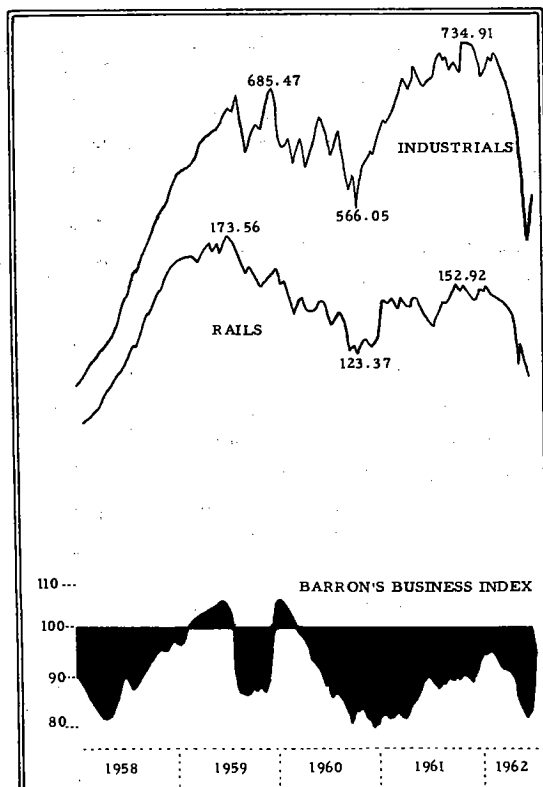
Because of the rare "crash" action of the market in May and because the Industrial Average has broken a thirteen year ascending trendline (see Letter 183), I have received numerous requests for a comparison of the 1929 market-business action with the current relationship. The accompanying charts show the progress of the Industrial Average and Barron's Business Index through the 1929-32 period and through the 1958-62 period.

Barron's Business Index is admittedly weighted by industrial factors (steel, petroleum, power, coal production and car-loadings), but these are the elements that make for real cyclical swings. The years 1935-39 equal 100 on Barron's Index. The Index is properly adjusted for seasonal and population change).

In July, 1929, Barron's Index turned down. Two months later the market collapsed. Few people in 1929 suspected that "The Great Crash" would be followed by the longest and deepest period of economic contraction in modern history. It may be said of the Averages during 1929-32 that they were faithful to the end.

Certainly the massive drop in Barron's Index through 1930 and 1931 appeared to be "deep enough" to satisfy the blackest pessimist. But the market was adamant in saying that the depression was going still further. Nothing in the Averages implied a reversal until the final "exhaustion" bottom of June-July, 1932.

In the present situation, it is possible that historians will elect 1959 as the year in which business and most stocks recorded their highs (see chart). Certainly the failure of the Rails to better their 1959 peak



Page 4 was a minus in the 1960-61 picture. Throughout 1960 and 1961 Barron's Index seemed to be confirming what the rails (carloadings) were implying -- that business in 1960-61 was expanding but that the economy was "tired".

As of the latest reading, Barron's Index has been flirting with its 1959 and 1960 recession lows. The drop in the Index from its January, 1962 peak of 94.9 has been steep and relatively unabated. It remains for the Averages to tell us whether the situation will worsen or not.

Of interest is the fact that during the 96 point upward reaction of 1929-30, Barron's Index lifted grudgingly, then rolled over and started down again. If the current market rise is merely a reaction in a bear market (and we have no right at this time to believe that it is anything else), then the cyclical forces in business will probably provide no better showing than they did in early 1930.

Thus, from the businessman's viewpoint the market has signalled danger ahead. It has not said how far the contraction will last or how far it will carry. Nor has it provided any hint that the end of the contraction is in sight.

LATE NOTES (written Monday, July 16, 11 P.M. N.Y. time). The rally showed signs of tiring during most of last week -- with the Averages evincing little ability to extend their gains. Over the last twelve trading days we have had only a single day of decline, and this fact alone favors a correction.

This morning prices worked lower in lazy trading. If the decline is to start here, it could be a deceptive down-movement (perhaps taking the form of a descending zig-zag) with volume rising at lower levels. The ten-day average of odd-lot trading (as of today) shows the heaviest rate of odd-lot buying this year -- 10 shares purchased for every 7 sold -- and this is another element favoring a correction. If a decline materializes, and if odd-lotters further increase their buying with lower prices, the drop could go further than anticipated.

The Averages are entitled to the normal $1/3$ to $2/3$ correction of all movements -- whether minor, secondary or primary. My feeling here is that if we are to receive a normal correction of the advance since June 26, the expectation would be for a $1/3$ to $1/2$ retracement of the 55 Industrials points gained since that date.

STOCKS "What puzzles me," says the sage Mr. Humphrey Neill in his latest letter, "is the apparent indifference of people to the severe collapse of prices in Wall Street." This is a shrewd observation. Plenty of people are ready to speculate on a major recovery (odd-lotters certainly are), and this bothers me too. However, for those who are ready "to take the bit in their teeth", I suggest buying when the next (or current) decline shows signs of running its course -- with the stipulation that a joint penetration of the Averages through the June lows (see page 1) constitutes an "exit signal."

There has been enough upside action over the past few weeks to aid me in spotting some of the stocks that seem to "want to recover." I list these stocks as Kaiser Aluminum, Standard of California, Royal Dutch, American Can, Polaroid, Magnavox and Beckman Instrument. I would suggest that speculators buy "a package" of these 7 stocks (and I don't care if they buy five shares of each or 100 shares of each).

Those who have purchased the golds as recommended in previous Letters and in Letter 184 now have nice profits, and I suggest selling $1/3$ of those commitments for "insurance" purposes.

I include a chart of Magnavox showing an almost completed "reverse head-and-shoulders" formation. Another drop might aid the symmetry of the "right shoulder", but at any rate a rise above the dotted line at 35 on increasing volume would be the "breakout". (The solid black line is the relative strength line). This chart is typical of perhaps 70% of the stocks on the Board -- but we still need the break-outs -- which would correspond with a second upward thrust of the Averages.

Chart of Magnavox courtesy of Traders Research, P. O. Box 2644, St. Louis 16, Mo.

